POLITICS AND TRANSITION LAGS IN SOUTHEASTERN EUROPE: WILL, ABILITY, OR POSSIBILITY[1]

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Introduction

The opening of the EU enlargement process provided by the Nice European Council, the adoption of the Stability Pact for South Eastern Europe in June 1999, and the recent removal of political blockages to cooperation with Yugoslavia provide a better framework for addressing the region's political and economic problems. Identifying the more precise configurations and sources of these problems is now an urgent matter. As the old saying goes, "if you don't know what is wrong with something, you can't fix it". In that spirit, this paper investigates the contribution of political problems to the relatively poor economic performance of Bulgaria and Romania, the two leading countries of the region.

The literature on policy failures in the political economy of reforms (Robinson 1998) suggests several sources of political problems. Political agents might misunderstand what drives the economy or they might be ignorant of relevant facts and make wrong forecasts. The sharp break from the past, that characterized transition countries in general, surely made such misunderstanding and ignorance likely. The sharper the break the more likely the problems. With nascent democracy, political leaders might be unable to pass the right laws because of weak coalitions. Then administrators might fail to carry out even good laws because they lack required skills or right incentives. Possible negative reactions of the median voter to the perceived effects of reforms might further constrain reform-oriented politicians. Moreover, even in transition countries voters are divided into interest groups of unequal power. Aside from possibly catering to different voter groups, politicians have different motivations. There are many different visions of the public good that might attract idealistic politicians. Beyond this, politicians, like ordinary people, have selfish interests. The literature on developing countries emphasizes the role of material self-interest and the possibilities of coalitions of rent-seeking elite obtaining political power, even in constitutional democracies. The immediate transition conditions provided fertile ground for the rise of such coalitions of self-interest.

The politics of transition economies can be seen as centering on two processes. First, property rights in non-human wealth (land and structures, natural resources, machines and factories, office equipment, domestic and foreign cash and bank accounts) are redistributed to physical persons and bureaux. Also, control of the latter is redistributed among bureaucrats and officials. Second, the processes of allocation, production, and distribution take place under the influence of the emerging new structure of ownership and control and new transfer mechanisms and market processes, some spontaneous and others defined by new legal rules. While considerable writing on the politics of transition has concerned the justice and equity of the redistribution process, this paper is concerned with the effects on the efficiency of the economy of the emerging structures of ownership and control rights and the new transaction rules and mechanisms.

The paper approaches this subject by first reviewing the empirical economic literature in order to identify what institutional and policy reforms lead to the best transition performance. It also reviews

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how well, on the average, have transition countries achieved those institutions and policies. This gives a standard to judge the performance of Bulgarian and Romanian politicians. Second, it briefly considers how countries reform achievements might have been affected by the initial conditions each faced. Researchers associated with the World Bank and the EBRD have incorporated one set of initial conditions in their research. Petrakos (2001) has emphasized some others in his explanation of performance in transition by the Southeast European Countries. Third, the main issues in the literature on political economy of transition countries are reviewed. Fourth the Bulgarian and Romania records of transition reforms are reviewed together with brief overviews of their main political changes. The conclusion ties all of these parts together in order to evaluate the quality of transition politics in each country. Finally, a few recommendations are made for the design of programs to improve these countries performance.

What Institutional and Policy Reforms Lead to the Best Economic Performance in Transition?

What institutional and policy reforms are generally considered to be the basis for the best growth performance in transition? Blanchard (1997) sets out a model in which a transition economy has two sectors, initially a large state sector and a small private sector. State-owned enterprises (SOEs) lose output and start retiring employees early because of difficulties of adjusting to the loss of exports to CMEA countries, disorganization due to the collapse of ties enforced by the old system of central allocations, and others. Private enterprises increase through new establishments, but their effect on total output and employment initially can not offset the declining state sector. Problems of SOEs prove difficult to correct through restructuring and privatization. They often receive soft-budget funding. Even after privatization they tend to perform poorly because of poor incentives and continue to receive soft-budget support. The best performers have been those having a controlling foreign interest. As the robust part of the private sector (new establishments and foreign enterprises) grows it starts to offset the state sector's decline or stagnation. Then overall GDP can start to recover and can be followed by an increase in employment. has been supported by empirical enterprise studies (Faggio and Konings 1999, Bilsen and Konings 1998, others). Comparative analysis of Bulgarian and Romania enterprises not only shows weaker performance across all ownership categories, but also suggests that privatization of SOEs does not improve performance. There is good reason to believe that this particular weakness arises from the dominance of weak forms of insider control in these two countries.

A complementary line of empirical economic research focuses on macroeconomic and "macro-institutional aspects of transition. It links differences in output growth to differences in initial conditions of countries, inflation and budget balances, liberalization, and other indicators of economic, legal, and political reforms. This research not only reveals what have been the common or "average" experiences of 25 transition countries and thus sets what might be thought of as a reasonable set of policy attainments. It also helps identify the effects of adverse initial conditions and how they might be overcome through appropriate reforms of institutions and policies. Papers by Krueger and Ciolko (1998) and Heybey and Murrell (1999) throw doubt on the positive effects of liberalization on growth. The first found growth and liberalization were both determined by initial conditions. The latter even suggested that increased liberalization causes output to fall. Three more recent papers (recent by data and period of preparation) convincingly challenge these two papers. They have a consistent result using panel data showing that the initial effects of liberalization or strong stabilization measures usually accompanied by an output to fall in the immediate year, but then a more than compensating growth in the following years. Also, the effects of initial conditions decline and eventually disappear. Berg et al (1999) incorporates a Blanchard-like two-sector model in order to address an important issue: "It is sometimes argued that some countries 'could not' engage in radical reforms because their initial conditions were too adverse (p.49)." They then conclude, " ... fast liberalization benefits growth ..., not just in the sense that economies in a more liberalized *state* grow faster, but in that choosing a faster *path* to this more liberalized state does not imply an offsetting cost. ... Adverse initial conditions do *not* seem to have affected the efficacy of policies"(p. 53, emphasis in the original). Falcetti, Raiser and Sanfey (2000) with similar conclusions add an important caveat concerning the EBRD's liberalization index. If it is treated econometrically as an ordinal indicator then the strong positive effects of liberalization on growth disappear as transition countries approach liberalization standards of the advanced industrial countries. This indicates something more is necessary to explain differences in growth once transition countries reach some "reasonable" level of liberalization. Havrylshyn and van Rooden (2000) identify the positive impact of better "market-supporting institutions" (the unweighted average of the EBRD indicators of governance and enterprise restructuring, competition policy, banking reform and interest rate deregulation, and securities markets and non-bank financial institutions).

An important aspect of transition reforms, large-scale privatisation, has so far been left out of this line of research. The EBRD indicator is this case reflects the total share of privatized enterprises regardless of method of privatization. As enterprise studies show, privatized SOEs do not improve performance irrespective of the quality of ownership and governance and the extent of soft-budget constraints after privatization (Nellis 2000).

Initial Conditions and International Spillovers

The above-cited macro-oriented empirical economic research investigates the experiences of 25 transition countries and, thus, provides a wide basis for comparing what has happened in the SEECs. Each country's GDP growth, inflation and budget-balances, and related reform indicators are data for the econometrics. Also, important aspects of each country's initial conditions and whether or not it has been involved in war or armed domestic conflict are part of the data.

The initial conditions used originate from a paper by DeMelo et al (1997) that compiles a list of some twelve or so specific indicators.[2] This list is subsequently slightly modified by the EBRD and is reported in the *Transition Report 1999* (p.28). So many variables obviously present a problem for regressions on a data based of 25 countries and perhaps eight or more years' of observations for each one. Thus, two of the papers above are based on a simplification of using the first principal component, which covers about 50 percent of the total variation across all indicators. This index weighs heavily the initial level of GDP per capita, distance to Brussels, distortions in the sectoral allocation of employment, years under central planning, and macroeconomic imbalances (suppressed inflation and the black market exchange premium). Berg et al (1999) test the effects on growth of each specific indicator taken separately and then also estimates their combined effect.

One can rightfully question if this list of specific conditions (and also their first principal component) accurately and fairly reflects the problems facing the SEECs at the start of transition and during the course of transition in consequence of international spillovers. Petrakos (2001) emphasizes, in addition to distance from Brussels and per capita GDP, that are included above, the following conditions:

(1) Country size

(2) Neighborhood spillovers and interactions (cross border trade and cooperation, arms trade, crime and violence, disruption of transportation routes, etc)

[2] The indicators are: 1) GDP per capita in 1989, 2) pre-transition growth rates, 3) a natural resource dummy, 4) the urban share of population, 5) distance from Brussels, 6) share of employment in industry, agriculture and services relative to market economies at similar levels of GDP per capita, 7) repressed inflation estimates, 8) the black market exchange rate premium, 9) years under central planning, 10) the level of CMEA trade dependency, 11) private sector share of GDP, and 12) a dummy for state capacity.

(3) Export strength in EU markets
(4) Inter-industry and intra-industry structural distortions
(5) FDI flows
(6) Ethnic fragmentation
(7) Shocks arising from the loss of payments in oil from Iran and Iraq for previous exports.
(8) A special aspect arising from CMEA trade dependence because of the integration of specific industrial enterprises as was common in Bulgaria's case.

Any attempt to add these indicators will run into some problems. Can such indicators be found for all twenty-five transition countries? Would their addition affect the ranking of the first or second principal components or other means of decreasing the number of independent variables in a regression? Would the country ranking change in terms of the relative difficulties of their initial conditions? Doubts remain until more detailed research is done.

The Political Economy of Transition

The dominant line of political economy of transition focuses on a dilemma raised by Aghion and Blanchard (1994). In the Blanchard model initial employment is large in the troubled state sector compared to that in the private sector. Quick stabilization and liberalization, given other problems faced by state-owned enterprises, makes it difficult for them to pay wages and to maintain employment. It causes them also to try to eliminate social services (healthcare, nurseries, vacation facilities, etc.) that were provided by large enterprises under the old system. Profit transfers to the state budget plunge. While employment and possibly tax payments in the private sector increase, initially this cannot compensate for the declines in the state sector. Subsidies paid to maintain state-sector employment and wages interfere with needed restructuring and stabilization. Also, it takes the few available resources of the budget away from possible promotion of new private enterprises. On the other hand, if a cautious approach is not taken, unemployment might rise and average incomes and social benefits might fall for the median voter. Then politicians initially in power risk being voted out at the next election. Dewatripont and Roland (1992) advise a gradual approach to stabilization and liberalization in order to avoid a political reversal of reforms. Balcerowicz (1995) has a variation to this approach. Reformers, who are lucky enough to come into power in an initial popular movement against the old system, should go as fast and as far with reforms as possible during the "period of extraordinary politics" following their takeover of power. Even moderate reforms are likely to be blocked as the unavoidable negative effects start to be felt by the people and the window of opportunity is lost. This sound logic unfortunately does not account for the subsequent political experience of fast or moderately fast reform cases like Poland and Hungary. While the second election did replace the first reformers with post-communist socialist governments, these governments essentially continued the reform policies and even, in the case of Hungary, undertook needed labor and social reforms that furthered liberalization.

Boycko, Shleifer, and Vishny (1995), reflecting their experience in Russia, see the essential political problem of transition as using the moment of opportunity following the change in government to break the power of the central administrative apparatus before it can mobilize the opposition to reforms. Quick privatization to managers and workers of state-owned enterprises provides a well-financed support base to oppose the old bureaucracy. As Aslund (1995) points out, other means such as highly profitable import and export licenses, negative real interest loans, and toleration of tax arrears were also used to create rich support groups. Unfortunately, once the new oligarchy was formed it used its power to block further reform steps.

The two approaches together point up a problem in transition political economy that has been important in the political economy of reforms in developing countries. What keeps governments of opportunists from making alliances with elites by trading privileges for political support and material benefits? What prevents such an oligarchy from taking power and then blocking subsequent reforms that might endanger the flow of economic rents. Such themes have certainly been part of the literature on political economy of reforms in developing countries in renting-seeking approaches of Krueger (1973) and others. The predatory state is part of economic history since North (1981) has emphasized it. A few years ago the author cited remarks of Albert Fishlow (1990) that are relevant for transition economies:

> "The domestic managers of state enterprises and even those of private firms did not achieve their positions as a result of victories won in the marketplace. In some countries they were likely to emerge from the military; in virtually all, they would have had extensive public experience ... The theory of rent-seeking posits that the managers who would be most successful in this climate of state activism would be those who were especially privileged by public intervention."

This approach is closer to the political economy of transition propounded by Fish (1998) and Hellman (1999). They both found the best way to forecast the speed and comprehensiveness of transition reforms, both economic and political, is by the character of the first post-reform government (and head of state). When clearly anticommunist governments first took charge, reforms went fast (Poland, the former Czechoslovakia) or relatively fast (Hungary). When slightly whitewashed former communists took charge, reforms were slow, resulting in what Hellman calls a "partial reform equilibrium". As compared to either no reforms or comprehensive reforms, partial reforms offer the greatest opportunities for rent-seeking. Hellman offers evidence indicating that income distributions have become more unequal in slow or partially reformed countries than in those comprehensively reforming. For Fish, the politics of the first election tends to be extended. In the latter with no real initial political change, the former communists burrow deeply into positions of advantage (top bureaucracy, SOE and bank managers, judges, county prefectures, etc.) and cement their political forces, while only weak opposition groups develop. Slow economic reforms limit the number of independent sources of support for both opposition parties and NGOs. Thus, the partial reforms process can be extended into the second post-communist election and even beyond. Referring to countries with no real change in the character of leadership at the beginning of transition, the EBRD *Transition Report 1999* (p. 106) says,

> "Incumbent politicians have tended to prefer the status quo, believing that economic reforms would undermine their interests. When placed under pressure by external agencies, principally the international financial institutions, such politicians often implemented reforms in ways that preserved or even extended the privileges available to existing elites. In these countries, both liberalization and stabilization were delayed."

Not explained in either approach to political economy of transition is why some countries experienced a fundamental regime change while others did not. In order to answer that question in general terms it is useful to review what might have been the motivations and incentives of potential political actors on the eve of the transition. In this contrast, *motivations* refer to a person's values and their rankings. What are people seeking? And what are the limits on means that might be used to achieve ends? Commonly people seek more than one state or goal. It can be something seemingly simple like having a reasonable material existence, having a good holiday, and staying out of trouble. Some are more ambitious, to be a great athlete, artist, scientists, or philosopher. Some would like to be as rich as possible, to acquire power or to be seen as a great national leader. Still others might seek to serve God, to care for the poor and the sick. There is nothing unusual about the array. The question is, how life, society, and education under communist rule affected motivations? Moreover, motivations are usually not equally or randomly distributed among all members of society. Persons carrying out different roles and functions might have sorted themselves out according to motivations needed to attain those positions. Thus, motivations might differ according to one's role and function in a society.

Incentives, in this dichotomy, refer to the possibilities offered by one's physical and social environment for realizing different objectives. The relative costs of alternative objectives differ and one of the factors affecting relative costs is one's human capital and one's position in the society. Transition can be conceived of a relatively abrupt change in the structure of incentives facing all members of the society. Politically, one could now rather freely engage in politics (shorthand for all kinds of activities suppressed under the old system) and advocate whatever one wants. Economically, the new horizon was also vast. One could achieve income and wealth by engaging in business of all kinds. One could invent and profit from the invention. One could become a writer of best sellers on themes and for markets that were prohibited under the old system. Other avenues for the ambitious and the talented were open.

At the same time, other avenues for income and even instantaneous wealth were opened. As the old order collapsed or was replaced, one might take over economically useful physical capital, varying from the corner kiosque, some land and machinery of the agricultural cooperative or state farm, to a whole industrial plant. Office equipment and press equipment might be grabbed. Supplies of valuable fungible products or collections of rare and valuable art objects could be taken. Even bank accounts, some abroad, and cash could be taken. The opportunity to benefit in these cases depended upon the degree to which the old order of social control collapsed and the length of time it took to replace it with a new system of control suitable for a new market economy. Also, there were other opportunities that arose for obtaining places of influence and privilege in the new offices of public administration that had to be set up.

It is not possible to empirically identify this framework across the transition countries. This would require a detailed tome in contemporary history even for one country. Nevertheless, some initial conditions that might account for know differences across countries can be identified. There were big differences in the degree of "closedness" and autarchy of countries before transition. The most closed societies were North Korea, Albania, and Romania. Much of consequence seems to arise from closedness or openness.

The potential to cope with a market economy depended on the extent of intended decentralization under the old system. It was high in Hungary and the former Yugoslavia, but nearly non-existent in Albania and Romania. A related difference was the extent and nature of "business" conducted in the West. How many people were actually involved in negotiations and what kinds of products and services were they selling? Had legal and administrative alternatives to "state enterprises" been developed? How many economists were there, including noteworthy expatriates, who dealt seriously with market economics?

Politically how far had elite groups separated themselves from old style communist dictatorships? What were the experience, strength and objectives of reform groups, if any? Did reform groups have strong lines of support in the West like the Poles had in the Catholic Church? Were there respected non-communist public figures? How much scrutiny of the nomenklatura and their privileges was there and how widely was it published? Finally and not less important because it is listed last: what was the mindset of the nomenklatura? How much did they feel abused and deprived of public respect and material rewards for keeping public order and trying to keep the old system running? In the author's long experience in Romania every highly placed person at some point took pains to point out how humble was his remuneration compared to a western counterpart and yet how little appreciated he felt by either the leadership above or the common people below.

The Cases of Bulgaria and Romania

Prelude to Transition

At the beginning of the communist period, in both Bulgaria and Romania about three-quarters of the population lived in rural areas and about the same proportion of the active population was in agriculture. While Albania and the most southeastern parts of Yugoslavia, today's Kosovo and Macedonia, were less developed, the least developed parts of Bulgaria and Romania were similarly situated (Lampe and Jackson 1982). Rock-solid communists ruled both Bulgaria and Romania before transition. Both pushed their countries' industrial development beyond the level and structures that could be sustained even in the hot-house of the old system. Greater proportions of resources became involved in what would have been negative value-added operations, if valued at international market prices. Both populations were pushed hard to accommodate. Nevertheless, important political and economic differences between them emerged (Jackson 1991a, 1991b).

Bulgaria early on pushed agricultural mechanization and light industry in provincial towns thus urbanizing more of its population by the 1980s. Also, by orienting its trade with the former Soviet Union and intertwining its industrial enterprises with Soviet counterparts it received favorable terms of trade, including virtually unlimited supplies of cheap energy and raw materials. Romania turned away from the CMEA towards the Third World and greater self-sufficiency. It was forced to suspend foreign debt payments early in 1980. Then Ceausescu pushed the economy to mobilize all possible exports and cut imports to the bone. While the debt was repaid at the time of transition, consumers and industry had been weakened by the effort. Bulgaria's foreign debt exploded after 1985 and it prolonged and then effectively stopped service late in 1989. Both countries claim to have lost significant payments in oil for industrial supplies exported to Iran and Iraq in the 1980s. Only Bulgaria felt a big shock with the collapse of CMEA economic relationships.

With the notable exception of Albania, both countries were more highly isolated politically from the West than were other communist-ruled countries in the area. Neither had famous reform movements and leaders. Neither had well-known expatriate economists and other intellectuals. Nevertheless, Romania's dictatorship was far more draconian, politically and economically. Bulgaria's party and government discussed moderate decentralization in 1987 and even introduced a bit by 1989, just enough to start its nomenklatura positioning for possible profitable places in the economy (Jackson 1989). Outside their embassy commercial offices in the OECD countries, Bulgaria had a few companies set up for industrial cooperation in machinery, while Romania had only two that were oriented to trade (Gabanyi 1999). Otherwise, the embassy commercial officers conducted its western-cited activities.

Political Transition to the End of 1996

Transition plopped on the scene in Bulgaria in November 1989 when top party officials voted Zivkhov out. It exploded into the open in Romania, although whether in a real revolution or a coup d'etat is still debated. The result was the same. In both countries old communists trying to look like social democrats won the first elections in 1990. Neither election was judged to be "free and fair" by international organizations. Civil disorder and strikes then seemed to set Bulgaria on a different political course. Its prime minister resigned in late 1990. There followed provisional governments that sandwiched a government of the non-communist opposition from 1991 to 1992. Then the former communists, now socialists, won again in 1994 and governed to the end of 1996. By contrast, the political leaders of former communists in Romania put down civil disorder and strikes in both 1990 and 1991 with violence.

Still, they won an election in 1992 in with voters seem to have been more manipulated than ballots and stayed in power until losing an election in late 1996.

Despite the interregnum of provisional and opposition governments in Bulgaria, both countries enacted similar partial reform measures between 1990 and the end of 1996. In both economic performance, especially in the longer run, was weakened and fell below what might have been possible under better reform regimes. Also, a good case can be made that those who benefited most were those connected to the former regime, the managers of state enterprises, members of the former state security services turned businessmen, and from all reports many administrators and politicians who could trade favors for bribes.

Rent-Seeking and the Character of Economic Reforms

Some direct evidence

Two quite different kinds of evidence are available as a basis for judging the character of the politics behind reforms in Bulgaria and Romania. Some limited evidence points to specific cases and situations. Someone ready to research the press and contemporary reporting in both countries could collect much more information.

Gabanyi (1999) raises the issue of what happened to foreign bank accounts, estimated in value between US$ 400 million and 5 billion, controlled by the Ceausescus and their closest associates. The records known to exist after the regime's collapse disappeared. Investigations have been closed off on national security grounds. The prime minister even forbade the showing of a Canadian-produced documentary on the subject. He happened to have been Ceausescu's trusted man for administering such funds in the ministry of finance in 1989. Assets of foreign trading companies that have been linked to the security services and arms procurement and trade remain unaccounted for, while some individuals responsible emerged soon in 1990 as part of Romania's *nouveaux riches*. No good accounting of the assets of the RCP and its leader in Romania, estimated at a value as high as US$ 2.2 billion, has been made. Some individual items ended up in the hands of nomenklatura as personal holdings (sometimes via an intermediary of a state company or state-controlled foundation). Some members of the politburo and ministers of the government or their children, sons-in-law, or stepsons also quickly joined this group. A former minister of agriculture seems to have made his fortune as a member of the so-called "grain mafia", whose members received privileged licenses for imports needed for relieving food supplies stressed because of Ceausescu's draconian export policy. His son-in-law has been and now again is a prominent politician and since November 2000 again in the Romania government.

In Bulgaria, questions should have been raised by official accounting of the country's foreign debt increases from 1985 to the end of 1989. Some 40 percent of the total increase was identified on the uses-side as "errors and omissions" in a once "confidential report" (Bank Advisory Committee, 1990, Annex Table XVII). Normally, most errors and omissions arise from unaccounted capital flight, but these sums or part of them might have ended up in foreign banks without ever having been turned over to the Bulgarian National Bank. It is not known if a better accounting was done subsequently. At the same time, perhaps such funds provided basis financing both for officially-established but off the record foreign companies or for privately controlled companies that became the basis of Bulgaria's early *nouveaux riches*. A highly placed member of the government and the party in the late 1980s, Ognyan Doynev, became a prosperous and well-known Bulgarian businessman in Vienna. His case was investigated, but the Austrian government refused his extradition requested by the Bulgarian authorities.

In Bulgaria's case, according to Oxford Analytica (1995) as published in the World Bank, *Transition*, (6:3,1995, p.5):

> "Business groups in Bulgaria, run by former officials of the old communist regime, wield enormous economic power, largely because of the continuing strength of the patronage networks and other personal connections linking members of the old nomenklatura together. Several of these "red conglomerates" are descended from businesses established abroad as fronts for espionage work in the 1980s. Multigroup -- which controls most of the security and protection firms in the country, staffed largely by former athletes and ex-state security officers -- for example, has its roots in the old first, second, and sixth main directorates of the communist-era Committee for State Security. The Tron business grouping is largely based in the old scientific surveillance establishment. Until mid-1994, the most important of these groups were united in the so-called Group of 13 (seven now remain in the group)."

The report goes on to explain that the red conglomerates engaged primarily in trade, importing raw materials for sale (at high prices) to state-owned enterprises and buying SOE output on the cheap to sell it abroad at higher prices. The SOEs then accumulated debt, were bailed out by the banks, which in turn were bailed out by the National Bank or the state budget. Bribery and extortion often lubricate these channels, which involve privilege access to foreign trade permits, or subsidies and loans. Although such business group activity started to expand in 1989 and especially in 1990 during the government of Lukanov[3], Oxford Analytica fingers the two years of the Liuben Berov government (1992-1994) as a period of blossoming. Reneta Indzhova, who led the caretaker government that took over when Berov quit in 1994, named the Berov period as the "government of Multigroup", although it can be doubted if this was his intention (the author of this paper has known him personally for many years).

The Nature of Transition Reforms of Institutions and Policies

Slow and partial reforms are recorded on all major aspects of reforms in reports of international agencies and papers prepared by researcher from the countries and the West. In the EBRD *Transition Report 1997,* as a consequence of political actions from the end of 1989 to the middle of 1997, out of 25 transition countries Romania ranked 11th from the bottom in its average of all EBRD reform indicators. This put it behind Kazakhstan, Georgia, and Kyrgystan! Bulgaria managed a higher ranking, but it was behind Russia, Croatia, Lithuania, and Latvia as well as the six "leading" countries (including Estonia) for EU accession. Behind this, consider the follow record:

(1) *Initial statements about preferred economic systems*. Both countries' former communist, now "socialist" leaders in 1990 proclaimed their intention to set up some kind of market socialist economy with a "French-style" planning system. Also, their leading economic advisors reflected the Galbraithian view that even in functioning capitalist economies, markets were divided and prices, wages and taxes were decided by direct bargaining among the heads of big companies, trade unions and government ministries. Competitive markets with Schumpeterian competition were not only ignored, but treated as undesirable. In both countries attempts were made to blame undesignated "speculators and profiteers" for the problems of ordinary people such as rising unemployment, falling real value of pensions, and declining public education and health services. This old populist jargon help hide the issue how much subsidies given to favored enterprises and their workers took away support for better pensions, public education, and public health.

(2) *Liberalization and market distortions.* Both countries have been classified in the EBRD *Transition Report* as "slow liberalizers", a term encompassing domestic prices, foreign exchange and trade, and small-scale privatization. In 1996 they were the first countries to show reversals of the

[3] Lukanov was shot two years ago in a still unsolved murder.

overall average of liberalization and small-scale privatization indices. The only other countries to show such reversals were Slovakia, Belarus, and Tajikstan. (Falcetti, Raiser and Sanfey 2000, 18). Detailed and comparative analysis of market distortions in both countries with the CEECs can be found in Dobrinsky (1994), Jackson and Biesbrouck (1994), and other studies that were part of an EU project on "The Economic Interpenetration between the European Union and Eastern Europe".

In Bulgaria, during 1993 and 1994 the provisional government extended indirect control to cover about 30 items. A law on prices adopted by the socialist dominated parliament in September 1995 went much further towards the reduction of market determination of prices. By early 1996 approximately half of consumer goods (as weighted in the consumer price index'basket') were officially monitored or controlled. Both controlled price-margins and controlled prices were also common in the case of Romania energy, basic foods, and medical services. In both countries the distortive effects on supply and the diversion into black or grey markets became greater as general inflation rates increased.

In both countries, distortions of prices, export embargoes, import duties and quantitative restriction, and continuing monopolies of state-owned enterprises in farm supplying, animal production, and market-processing facilities wreaked havoc in the food chain. Such distortions generated an artificial shortage of bread in Bulgaria. Subsidies in the name of agriculture in both countries went to large corporative farms and state-owned supply and marketing companies.

In Bulgarian industry a temporary rise in output had been concentrated in branches such as chemicals and metallurgy which were particularly energy-intensive and export-oriented. According to the OECD (1997, 3) the firms in these branches benefited from "undervalued currency, energy subsidies, payment arrears, and loose bank credit". A brief real appreciation of the lev during 1995 eroded away a price advantage and in 1996 the international market for metals weakened. Finally, from mid-1996 onwards, prices for oil and gas increased to world market levels, depriving Bulgaria's energy-intensive production of much of its competitiveness.

The Romanian government claimed to have abolished the system of multiple exchange rates at the end of 1991. Subsequently, however, administrative interference blocked market forces. The evaluation of Romania by the European Commission (EC1997, 20) found "a feature of Romania's trade policy has been the proliferation of discretionary and temporary reductions in tariff rates, in particular tariff quotas ...". In 1995 some half half of Romania's imports were subject to special arrangements, rendering largely irrelevant the country's import tariff schedule. Substantial new trade restrictions were introduced in 1996 (including derogations from the basic duties, export prohibitions and export quotas), in an attempt to curb a rising trade deficit. The trade and exchange restrictions led international lenders, including the EU and the IMF, to suspend financial assistance.

Overvalued currencies and extensive domestic subsidies with artificially low prices encouraged energy waste in both countries. The European Commission (EC 1997, 22) estimated Bulgaria to use two to four times more energy per unit of output than European Union economies." The EBRD *Transition Report* 1997 found "heavily subsidised energy consumption for both industry and households", made Romania one of the highest consumers of energy per unit of GDP in eastern Europe, about three times the OECD average. Early attempts to raise energy prices only led to an accumulation of arrears to energy suppliers (from both enterprises and households) and associated shortfalls in the production of electricity and petroleum products, which were bridged by imports.

Neither country developed adequate means to promote competition. In Bulgaria laws in 1991 provided *de jure* elimination of former monopoly structures and established an antitrust body. Parliament appointed a Competition Protection Committee in 1992, but developed no active anti-trust policy in important areas such as natural monopolies. The agro-industrial wholesale trade lacked an active antitrust policy. In 1997 stronger legislation was provided and a number of cases opened, but as of August 1997 there were no actions taken. The Committee lacked both resources and legal remedies. In the overall judgement of the European Commission, In the judgement of the European Commission (EC 1997, 21) in Bulgaria "Initial progress in demonopolization and restructuring state enterprises *stalled in the absence of clear political support* [emphasis added]. In the enterprise and financial sector, market disciplines remained largely absent"

A Romanian law regulating competition was passed only in April, 1996, to become effective on 1 January 1997. By setting up the Competition Council before going out of power, as it did in other cases, the outgoing government was able to appoint its people to key high regulatory bodies. The European Commission (EC1997, 26) found there were severe limits to free entry and exit in specific economic activities. "Romania remains a country characterized by a significant degree of government interference with the working of the economy." Furthermore, "some powerful groups that stand to lose from the current reforms are calling for more State intervention in the economy, more price controls and a return to old methods of economic management."

Slow liberalization and reform reversals have provided opportunities for great profits to those given import and export licenses (as recorded in Russia's case by Aslund). Large margins were also available for farm marketing organizations and others benefiting from extended controlled prices. Opportunities for rent-seeking through exchange transactions were promoted by the maintenance of price and quantity controls. Rent-benefits went not only those who could obtain a quota, trading license, or a favorable fixed price. These immediately became the source of granting privileges to favorites or in return for money under the table. It gave higher returns to those who would organize illegal trading. This involved pressuring farmers to turn over the harvest for marketing by legal and illegal dealers, but also the diversion of stocks of materials and small tools from warehouses and factories. Enormous resources were drawn to these activities. It was not done quietly. People quarrelled and even killed over the rents to be gained.

(3) *Macroeconomic stabilization.* In spite of having announced stabilization programs in 1991, Bulgaria and Romania experienced higher inflation than the CEECs, although not worse than the Baltic countries. Romania experienced triple-digit inflation through 1993 and neither one achieved less than 40 percent until 1995. Accoring to World Bank report on Romania in 1993, "Continued rates of inflation combined with *ad hoc* government price intervention, distort relative prices so that they no longer reflect domestic scarcity costs or relative prices in the international market".[4] The European Commission (EC 1997, 25) found that, "although formally independent and subordinated to the parliament, the [Romanian] central bank was subject in the past to a certain degree of interference from the government". According to Zaman (1999, 27) from 1994 to the middle 1996, the Romanian National Bank remonetized the economy by expanding money supply faster than the inflation rate and the growth of GDP. Partly to blame were large subsidies to agriculture and energy sector directly from the National Bank's resources, through direct and special credits. Two troubled state-owned banks benefited also from credits of 1700 billion lei by the end of 1996.

Along with Albania, both countries experienced macroeconomic stabilization reversals in 1995, 1996, and 1997. This shows up in the increase in inflation and government deficits of all three countries. Zaman says that "Practically, the NBR [the national bank] lost control of money and credit growth prior to 1996 elections". In Bulgaria the problem originated in a terrible abuse of the credit system (see below) which brought on a financial collapse. Partly at fault was also the efforts in both countries to "buy" votes by releasing funds for favored regions and favored enterprises (Zaman 1999; Wyzan 1998).

[4] World Bank, *Romanian Economic Report*, 29.03.1993.

(4) *Property restitution and small-scale privatization.* Although both countries passed agricultural land restitution laws mandating a return of property to peasant farmers before communist collectization, actual restitution became a political football, was resisted by collective farm management, and was followed up by extremely slow surveying and granting of clear titles. Often pressure was put on peasants and other land claimants by the local prefectures who were mostly controlled by the "socialists" to vote for the right party and pay bribes. Large supply, mechanization, and marketing organizations remained until late unprivatized and in the hands of the former managers, even after privatization. Until after 1996 most subsidies for the agricultural and food sector went to the large processing plants, supplier companies, and marketing companies that remained state-owned or were privatized as MEBOs by insiders. (Kopeva, Mishev and Jackson 1994; Jackson 1997).

Small-scale privatization was the one of the first forms of manipulation by political insiders for the benefit of political or financial supporters and friends or relatives. This involved the lease or sale retail and service shops, restaurants, hotels and inns, taxis and road transportation equipment, etc. Complaints and conflicts between those favored employees, and those with potential restitution claims were abundantly registered in the local press from early in 1990. The study of Bulgaria's case in Frydman et al (1993, p.34) begins a section on "spontaneous ("quiet" and "illegal") privatization". Thus: " ... members of the departing communist *nomenklatura* in Bulgaria, especially in the last months of communist rule, have attempted to divert to their private ownership a part of the state property under their managerial control". "Quiet" privatization, usually involving no illegality, relied on normative acts of the Council of Ministers in 1989 and 1990 (see specific references in the source) that did not provide for open, public, and competitive sales of state, municipal and communal property. Most "illegal" privatization occurred when shares in state companies were sold to insiders in violation of the existing laws and regulations. In addition, the managers of SOEs founded new private companies, sometimes fronted by friends and family, which served as suppliers or marketing organization under price terms that effectively transferred value out of the SOE. All too often, the financing came from state subsidies and bank loans. The latter then could not be paid back.

The means and problems of small-scale privatization in Romania were not dissimilar. A particular device was that of selling "individual assets" of state properties (Jackson 2001, 410). This was supposed to consist of excess items that could be separated from the SOE without affecting the company's main activity. It was not always the case. Sales were supposed to be by auction, but the bids were not always made public. By July 1993 some 2500 such assets had been sold. By 1997 almost all small-scale trade and service activity was in the hands of private operators.

(5) *Medium- and Large-Scale Privatization.* After the first debates about "big bang" versus gradualism were slowly resolved, no other aspect of transition has generated more controversy on both efficiency and equity grounds that the privatization of medium and large-scale enterprises (Nellis 2000). Also, as already noted the EBRD indices of large-scale privatization rarely appear in any economic analysis of the determinants of growth. The problem probably lies in the fact that the index is mainly quantitative and does not reflect governance problems associated with the systems of privatization oversight and the resulting forms of ownership. In 1996 Bulgaria scored only 2 on this index while only in that year Romania went from 2 to 2.7[5]. A 2 score means that a comprehensive scheme is "almost" ready for implementation and some sales already completed. In 1996 some 18 out of 25 transition countries are ranked higher than Bulgaria, including even Macedonia and Moldova. By 2000 Bulgaria scored 3.7 and only four countries ranked higher. It had passed even Poland, Latvia, and Lithuania in the judgement of EBRD experts. Romania went up to a 3, not much progress over 1996 and meaning it had after nearly 10 years of quarreling little "more than 25 percent of assets of former SOEs in private

[5] This is the score in the Report for 2000 and is a downgrading from the 3 given in the Report for 1996.

hands or in the process of being privatized, but possibly with major unresolved issues of corporate governance. Is such a record witness to political failure or must it be excused on other grounds?

In Bulgaria provisions to limit "spontaneous" privatization were included in a new Commercial Code of June 1991. The first law for medium and large-scale privatization was passed in April 1992 after much debate during the reform or anti-communist government. It provided for individual sales through a variety of mechanisms with the first privatizations taking place in 1993. A privatization agency handled large enterprises and branch ministeries smaller ones. Management and other employees were permitted to bid for up to 20 percent of shares on 50 percent discounts. In November 1994 payments for up to 50 percent of transaction values were permitted in Brady Bonds and up to 80 percent in domestic bad-loan bonds (ZUNKs). A voucher privatization scheme was put forth in 1994 with implementation beginning in 1996. Vouchers issued to all adult citizens could be used directly for share purchases or vested with one of some 92 investment funds, which received about two-thirds of the vouchers. By August 1996 only about 5 percent of the long-term assets of SOEs had been privatized. This was done mostly by direct sales and through management or management-employee buyouts (MBO or MEBO). By August 1997 the privatized share went over 25 percent, pushed up by the voucher scheme and by an "accelerated program" to foreign bidders, which featured the use of foreign consulting firms in the offers and sales. On this account, Bulgaria was starting to break through "a partial reform equilibrium".

This was not the case with its northern neighbour. A Romanian National Privatization Agency was set up in 1990 to develop a mass privatization program. It began to sell, lease, or contract out the management of enterprise assets, at first small retail outlets, and then 21 "early privatizations" in food, light and construction industries, some of which included foreign investors together with local management and employees. The author discussed one of these with the foreign investor. It involved much arm twisting and favors to the Romanian principals involved. The first Privatisation Law of 1991 created an institutional framework consisting of a State Ownership Fund (SOF) and five so-called private ownership funds (POFs). All together these bodies provided many good jobs for supporters of the government and its party. The POFs were established as state-controlled joint-stock companies in five different cities and each had a sectoral specialization as well as some common holdings. They were converted into Private Investment Funds (PIFs) in November 1996, just before the government left office. Some 6,400 companies were converted to share companies under the Commercial Code and then 70 percent distributed to a State Ownership Fund and 30 percent to five POFs. The law also provided for the distribution to all adult Romanians so-called "certificates of ownership", each of which had five coupons". The coupons could be traded or turned over to the five POFs either as POF mutual fund shares or as shares in a company managed by a POF. Also the coupons could be offered for up to 30 percent of a company by its employees in a MEBO (management-employee buyout), which was been the most common form of privatization. Although "certificates" had been distributed in 1991, not until 1993 was it possible for someone to decide their allocation to the POFs. In the meantime, many common people had sold their coupons to others. By mid-1995 some 1,100 companies or 13 percent were privatized mainly through MEBOs.

A new Privatisation Law was passed on 21 March 1995. Under the new Law, Romanians were distributed new issues of "vouchers" starting August 1995. The distribution of vouchers to all adult Romanian citizens started in August 1995. The vouchers could be used to subscribe to shares directly in companies or to obtain shares in one of the five POFs. During the mass privatisation process, up to 60 per cent of the ownership in an individual company may be sold for vouchers, while the remaining 40 per cent is to be sold for cash. Prices of assets sold for vouchers were based on the enterprise book value rather than on market evaluations. Most vouchers were exchanged against enterprise shares directly; only 14 per cent of the vouchers were exchanged against shares in the POFs. The average

Romanian received little of value from the certificates or vouchers; rather they have seen the programs as benefiting administrators and company managers.

The success of the new program was mixed. By the end of 1996, only 46% of all enterprises scheduled for privatisation were privatised. About 70% of small enterprises had been sold, but only 24% of medium-sized and 13% of large enterprises. These figures include privatized enterprises in which the SOF continued to hold important blocks of shares. Actual private ownership is less than these figures indicate.

In explaining why privatization was so delayed in Romania, Zaman (1999) emphasizes the self-serving nature of the POFs and especially the SOF, the power of which "created large opportunities for corruption, vested interests and a low credibility of the process".[6] The SOF was not interested in liquidating itself and avoided privatizing the most profitable in order keep revenues that could be redistributed to other favored enterprises. With the programs directly under the parliament, political involvement has been high. "Particular interests of specific groups are the main explanation for the relative failure: workers have feared losing jobs and subsidies from the government, managers have been afraid of losing their position and its privileges, government officials want to keep their hands in the affairs of the companies, and the politicians [remain] sensitive to interests of their localities." Finally, he adds, "former nomenklaturists have benefited in many cases from privatizations, keeping their elitist status in the society. ... Corruption is linked to this particularity ".

Compared to Bulgaria, Romania has had greater problems with its self-serving bureaucracy for privatization, which, in turn, offered politicians more opportunities to appoint favorites and to obtain insider information. In both countries MBOs and MEBOs predominated. According to Earle and Estrin (1996), managerial-controlled employee-owned firms where employee shares can not be transferred have bad incentive properties. Incentives are much worse in such firms that have little chance to survive. Managers will concentrate on obtaining subsidies rather than restructuring. One should add that, given the likely comparative advantages of managers under the old system, it is likely that they are better at rent-seeking that efficient management under market conditions. Hence, one might expect abuse of the management position by various forms of stripping assets, including transfer pricing to managers' own purchasing or marketing companies. After all, the managers in these cases have rarely committed their own assets to the formation of the firm and so lose nothing but the chance to continue stripping assets and to be paid if the firm collapses.

The case studies of Romanian MEBOs in Earle and Estrin (1996) are especially revealing of how Romanian companies were acquired by the former managerial groups. The law enabling MEBOs provided that they would be requested by an "employees' association" set up by a "group" of former and present employees. In fact, the controlling board of the association was usually identical the previous management board of the SOE. The "association" did not have to and did not usually include all employees or all employee-shareholders. It had unchallenged management authority until such time as the founding debts of the company were paid off. This included setting terms for any exchanges or sales of shares, both of which were usually prohibited. The linkage of association control with the repayment of debt puts in special perspective the usual loan advanced by the SOF in order to pay for the company shares (of course, in addition to any vouchers in the hands of the employees). Although the nominal interest rate on such loans could be high, it was far below the rate of inflation so the association benefited by highly negative real interest rates once it survived the first years of high nominal payments.

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[6] The SOF is legally required to cease operations in 1999, the date when the completion of privatization was initially envisaged. Formerly independent, it was restructured and put under the direct control of the government in April 1997.

According to Earle and Estrin (1996) the MEBO form dominated both Romania and Russia, in contrast to its virtual non-existence in the Czech Republic and its co-existence along with almost every other ownership form for possible privatization in Hungary and Poland. Clearly the MEBO also dominated privatization in Bulgaria up to the end of 1996. Hence, it is unfortunate that none of the enterprise studies comparing the performance of unprivatized SOEs with privatized SOEs do not identify the mode of privatization. This is done only in case of foreign investors. Every empirical study indicates that privatization improves performance (see the list reviewed by Bevan, Estrin and Schaffer 1999), except those including Bulgarian and Romanian enterprises. In those case few or no differences are found in performance after privatization. Perhaps this result is due to the dominance of MEBOs and their poor management properties.

A second common weakness in privatization in both countries is the relative lack of foreign direct investment in the process compared to the CEECs and the Baltic states. The question that needs to be answered is the extent to which low levels of FDI are due to one or the other of two sets of factors. On one hand are inherited and situational factors such as level of development, the initial quality of enterprise capital, distance from markets, country size, and others emphasized by Petrakos (2001). On the other hand are political, institutional and policy problems. Through the end of 1996 both governments clearly favored privatization to local elites rather than foreigners. The administrative framework required endless approvals and often changed. Property rights and other aspects of the legal framework were poorly defined compared to other countries. Corruption has also been a major problem for foreigners, who generally have been seen as both rich and naive.

(6) *Enterprise Losses, Debts, Banks, and Restructuring.* In both Bulgaria and Romania the SOEs began to show increasing financial losses from the beginning of transition. A good proportion of privatized SOEs also operated at losses. Initially the two governments covered losses by subsidies and increasing tax arrears. In 1996 the worst Bulgarian public firms with a negative profit equal to or less than 10% accounted for about 67 percent of all tax arrears in the public real sector (Dimitrov 1999). Dimitrov's study reveals an unexpected difference between public firms and private firms. Whereas among the public firms, the more profitable proved to be the better tax payers, among the private firms those with positive profits accounted for over half of the tax arrears and those with somewhat negative profits proved to be better taxpayers. In the meantime, the banks, mostly state-owned, become increasingly involved.

In both countries (Djankov 1999, 284) isolation programs were implemented, as in five other transition countries (Albania, Armenia, Kazakhstan, the Kyrgyz Republic, and Macedonia). They were designed to identify and then subject largest loss-making state-owned enterprises to assisted programs of restructuring and possible privatization or liquidation. In Bulgaria and Romania, under the governments ruling until the end of 1996, the isolation programs were largely failures.

According to the OECD (1997, 21) in Bulgaria gross state enterprise losses represented 15 percent of GDP annually on average in 1993-1995. In some cases enterprises might have been generating negative value added. The mostly state-owned Bulgarian banks provided the largest source of funds for covering enterprise losses. According to the OECD, 43 percent of the negative cash flow of state enterprises in 1995 was financed by the banking system. The EBRD Transition Report indicates that classified loans rose to 40 percent of GDP and 75 percent of the loan portfolio in 1995. Dobrinski, Dochev and Nikolov (1997) judge the series of bailouts of enterprise bad debt in Bulgaria from 1991 through 1994 to be the most expensive in relative terms of all the transition countries. ... The program initiated in 1993 alone replaced bad debts of enterprises worth 30 percent of the GDP on bank balance sheets with interest bearing government securities. Regretfully, where funds went or how debts were generated is not known.

The Bulgarian government adopted a new bankruptcy law in 1994, but no large SOE was declared bankrupt until the summer of 1996. Instead, according to Dobrinski, Dochev and Nikolov (1997, 11) the authorities tolerated low financial discipline and the accumulation of payment arrears. Loss-making firms continued operation as going concerns. The lack of financial discipline even spread to private enterprises and discouraged all from actively pursuing restructuring policies. The resulting rent-seeking, asset-stripping, and corrupt practices by company managers and state officials is called "profit privatization" by Dobrinski, Dochev and Nikolov. It was widespread in Bulgaria in the first phase of transition and resulted in a further deterioration of the financial situation in SOEs.

The European Commission (EC 1997, 27) echoes their analysis. “The problems of the financial sector in Bulgaria are connected with the situation of the enterprise sector. Imprudent lending, poor supervision, and an absence of ‘hard budget constraints’ resulted in mounting losses in these sectors, which derailed progress towards macroeconomic stabilization. At blame were “previous recapitalisations of banks were not followed by action to prevent a recurrence of bad debts.” That created an expectation that the state would ultimately bail out insolvent banks and firms, which spread beyond the state sector to the private sector. The EBRD *Transition Report 1997* pronounced Bulgaria’s banking sector insolvent in 1996, with estimates of negative net worth ranging from US$ 1 billion upwards. The intermittent runs on deposits during 1996 included a decline of foreign exchange deposits from US$ 2.2 billion down to US$ 1.7 billion between January and May. As Dobrinski, Dochev and Nikolov put it, “One can add that [the bailout program] had the worst possible consequences of bringing the country’s financial system to its knees.”

In Romania enterprise arrears had risen to over 1/3 of GDP by 1997/1998 (Zaman 1999, 33). Some 30 percent of these arrears belonged to 152 large loss-making enterprises. While in 1995 they received 92 percent of subsidies, these were only about 3 percent of GDP. Much of the arrears were owed to electricity and gas suppliers. Some “53 percent of state industrial firms have arrears to electricity and gas suppliers, to which 75 percent of total arrears in the economy are currently accumulated”. According to the Transition Report 2000, the share of bad loans in total bank loans rose from 19 percent in 1994 to a high of 68 percent in 1998 (conflicting figures are reported in the Romanian statistical yearbook).

A Romanian bankruptcy law was passed by parliament in March 1995. The law did not apply to the largest state sector companies, the “regies autonomies” (RAs) usually public utilities, for which special bankruptcy legislation was being drafted. Arrears continued to be a problem, partly because the law did not apply to RAs. In any case, hardly any enterprises were liquidated under the previous reform programs.

A formal state-financed recapitalization of Romanian banks started in 1991. The government bought from the banks 90 percent of their non-performing claims and then cancelled the loans - the total nominal value of which was Lei 150 billion or 68 percent of 1991 GDP. In 1992 the government injected another Lei 50 billion or 0.8 percent of 1992 GDP. As in the Bulgarian case, no one has accounted for the funds. Did they benefit workers or go into the pockets of managers? Further help came by large spreads between lending and deposit rates during much of this period. “Despite plans to increase bank privatisation, the sector continued to be dominated by State-owned banks, some of which had a high proportion of bad loans in their portfolios. “Five state-owned banks account for more than two thirds of aggregate assets, and for three quarters of commercial loans”, according to Zaman (1999, 32). He claims that over the whole period of transition the state companies have been the main beneficiaries of credits from the state banks. Moreover, “the credits provided to private companies by state owned banks have been given almost exclusively on a lobbying basis, with strong influence from politicians and even government officials. Such ties [between firms and government] also included selected parts of the private sector. “While at the end of 1994 this weight represented about one-third, in September 1997 [just before the elections when Iliescu went out of power] 65.7 percent of overdue credits belonged to private companies. The share of private sector in total credits in hard currency has increased from 3 percent at the end of 1994 up to 69 percent in September 1997.” Zaman attributed the situation to two problems. First, until end of 1996, loans were made on a political basis. Second, subsidies to agriculture were as loans through Banca Agricola. Third, in some cases, the SOF offered Romanian private investors postponement of unpaid debts of the company. As noted above, this was standard practice in the case of the MEBOs.

Perotti and Carare (1997) examine the relationship of performance and bank credit for Romanian state-owned enterprises over 1991-1994. They conclude that credit criteria used by Romanian banks show few signs of improvement. Bank credit appears negatively correlated with profitability, except when better firms reduce borrowing because of increasing real interest rates. Bank credit and financial arrears are strongly positively associated. Firm size was a significant determinant of credits until 1993 and then trade arrears became important in 1994. Banks appeared to be particularly soft towards the worse performing firms, particularly towards larger and more insolvent enterprises. ... Overall, the evidence suggests a largely passive attitude of banks towards the worse borrowers and only limited reallocation of credit to better users. Their bottom line (p. 26) is that, “Only a sustained period of separation of financial and political decision-making may pave the way for a stable financial transition in Romania.”

In 1992 the Romanian government required a group of loss-making firms with heavy debt burdens to design diagnostic reports of their financial situation and operation performance. The Agency for Restructuring was founded in the following year with the principal task of reorganizing troubled firms that would be sheltered from their creditors and receive technical as well as financial assistance in restructuring. In March 1993 about 300 loss making enterprises, which accounted for 70% of total enterprise losses, were targeted. Under union and other pressure, however, the government dropped many firms off the list. The selection resulted in having only 4 of the largest 10 loss-makers, defined as having the largest absolute operating losses in local currency, 46 of the largest 100 loss-makers, and 82 of the largest 300 loss-makers. “The program was thus deficient from the beginning as it failed to cover many of the worst firms that were beneficiaries of state funds” (Djankov 1999).

At the time of closing the program Feb 1997 only four firms had graduated. Two of them were privatized in 1996, while another two were liquidated. The new government in August 1997 closed down another 13. This closure was not related to the isolation program because other firms not on the list were also closed. During implementation only 7 of 147 CEOs were fired. Djankov (290) concludes that “isolated enterprises became increasingly less profitable, shed less labor, and received increasingly more subsidies than other firms in 1996 when compared with 1993”. “We conclude (292-293) that none of the intentions of the isolation program were fulfilled. Worse still, the program may have delayed restructuring by not imposing hardened budget constraint on loss-making enterprises and not forcing manager replacements. ... Loss makers were not selected by objective criteria and the agency in charge was not sheltered from political pressure in enforcing hardened budget constraints.”

Political Problems since the Beginning of 1997

In October 1996 *the Economist* (19 October 1999) evaluated Romania and Bulgaria in the following terms: “They have lousy economies and lousy rulers. There is little sign of prosperity, civil society, or rule of law. Things under the Communists were bad; under new rules, not so different in pedigree from the old ones, they are not vastly better. In some respects, they may even be worse. ... Romania and Bulgaria are among post-communism’s biggest flops.”

Both countries then elected non-communist, reform-committed governments at the end of 1996 or early 1997. Both new governments faced problems because of the budget deficits, inflation, and falling GDP they inherited. Both faced difficulties because of the distorted institutions, the entrenched old guard, delayed and weak privatization, and unrestructured economies. Clearly Bulgaria's financial and banking crisis far surpassed that of Romania.

Bulgaria's new government was far better situated politically than Romania's. Fortunately, Bulgaria's presidential election did not coincide with the parliament elections and the post-communists never elected a president. So during the crisis years, a president from the reform movement could intervene at a critical moment. The post-communist socialist Bulgarian government did not just lose an election; it had been forced out by public protests. The new government had a cohesive coalition with a clear majority and was subsequently not faced with a split in the ranks. The Bulgarian Prime Minister already had experience as a minister, while others in his government had governing experience as well. While old regime supporters were still implanted throughout the public administration, their hold had been weakened during the period of alternative governments from 1991 to the end of 1993. In contrast, the reformist parties in Romania were forced by a weak voter mandate to govern with the Democratic Party of Petre Roman. Roman had been Romania's first post-communist prime minister in 1990-1991 with Iliescu as president. The party was called a party of "sons and sons-in-law of the Nomenklatura before 1989", who were now entering middle age Gabanyi (1998). Roman had ambition to win the next elections as a center-left and proceeded to use his place in the coalition to undermine at least two of the three prime ministers and to delay critical legislation on land and housing reform, privatization, and banking restructuring. The other coalition parties spent more time quarrelling over personalities than issues. Even worse was infighting over prime ministry and party leadership of the leader of the coalition, the National Peasant-Christian Democratic Party. Unfortunately, the Romanian president proved to be a weak man in a presidency potentially as strong as that in France. Problems did not end there. As basic was the shear inability to get the politician's job done. Gabanyi (1998) cites the telling example of new privatization measures put forth by the new government immediately upon coming to office at the end of 1996. First issued as emergency decrees, the norms for their application were not approved until August 1997 and the instructions for applying the norms not issued until December 1997. Similarly, although the president signed a law for bank privatization in May 1997, the norms for application were not ready until August 1998!

Perhaps it is not surprising that following elections and in the next four years Bulgaria's government generated a better performance on nearly all critical aspects of reform institutions and policies than did Romania's three governments. Its best comparative performance was achieving macroeconomic stabilization by adopting a currency board. By the end of 2000 the privatization of enterprises and banks was nearly completed. While problems remained, much progress was registered in either restructuring or liquidating the worst structured and performing enterprises. As verification of progress, foreign direct investment jumped ahead. Positive GDP and even higher private consumption growth rates were registered in 1998, 1999, and 2000 and projected for 2001.

In Romania GDP and private consumption fell in 1997, 1998, and 1999, and hardly rose in 2000. All the time, inflation over 40 percent and even 155 percent in 1997 was recorded. While Romania made little progress, its government seemed better at issuing fine new regulations and much delayed laws than it was at putting them in action. Members of the government and parliament fought like scavengers over the corpse of a starved animal. Banks and investment funds collapsed or were taken under control in the midst of corruption scandals. Workers struck, demonstrated, and even rioted at major enterprises in opposition to restructuring or privatization plans.

Besides having a better initial political framework, why did the Bulgarian reforms move faster than the Romanian? One could not make a general case that Romanian enterprise and branch structures were initially more distorted than the Bulgarian ones. That, of course, might be demonstrated by detailed comparative research at the enterprise level, especially in the most troubled branches of heavy industry. A likely source of problems was that more Romanian enterprises were privatized as MEBOs with rules of operation that blocked restructuring and increased management opportunism. More than likely a close comparison of post 1996 privatization and enterprise restructuring would show the Bulgaria programs to be better designed and carried out than the Romanian counterparts. Also, it should not be overlooked that Romanian SOEs that could put off restructuring could hope for the return of a friendly regime at the next election. In fact, that seems to be the case although the policies of the newly elected Bulgarian government are unknown at this time.

These comparative and guarded evaluations can be followed in successive issues of the EBRD *Transition Report* through year 2000 and the European Commission's annual reports on "Progress towards Accession", including November 2000, the latest available for this paper. Similar material can be found in the *Economist Intelligence Reports* and the *PlanEcon Reports* on both countries.

While politics were a bigger mess in Romania than in Bulgaria, neither government scored well by international comparisons of the competence of government. Neither country enacted legislation to regulate and modernize the civil service until toward the end of the 1999. It was hardly soon enough to correct all previous shortcomings and abuses of public servants, including what some trusted informants in each country have called "moles" of the former communists. According to countries' institutional quality ranking in 1997-98 published in IMF (2000, 111), Bulgaria, ranked 75th, and Romania, ranked 82nd, were in the third quintile a bit below Croatia and in the company of such countries as Bolivia, India, El Salvador, Gambia, Mexico, and Lebanon. They were far below the Baltic countries and the CEECs.

Neither country's government seemed able to deal with endemic problems of inherited corruption. This "dark side" of life had been exacerbated by the continuing presence in the security services of old members who were suspected of using their network connections with the various successors to the KGB in the states of the former Soviet Union. Moreover, the encouragement of corruption was one of the worst spillovers of the wars in the former Yugoslavia and the difficult conditions in Albania. Yet both countries governments and presidents had made combating corruption a major issue. Their efforts brought few results. For example, following his party's poor showing in the local elections of October 1999 the Bulgarian prime minister said that his reform program had probably put too much pressure on the people. The Bulgarian president said the electorate was not reacting against reform, but in the inconsistent way it was being carried out and the corruption accompany it. He added that it had never been part of the deal that reform would be "a smoke screen behind which senior and junior officials, their relations and friends would get rich" (as reported in RFE/RL Newsline). Corruption scandals were a major issue through 1999 and 2000. Again on 19 April 2000 the president had to warn the prime minister that decisive steps had to be taken against corruption among senior officials. Such scandals were common in Romania. Accusations were even levelled against the president, something that never happened in Bulgaria. Not because of these accusations, but later even after declaring his candidacy for re-election, the Romania in July 2000, four months before the elections, withdrew. He blamed politics in the country as being corrupt and a blind struggle for power-seeking". It also happens that opinion polls had showed his support falling since at least in 1998 and behind his leading opponent since 1999. Nevertheless, corruption has been a major issue in Romania, as remarked in each EU evaluation of the country.

Comparative corruption indices have been prepared that look at both sides. That of the "grabbing hand" of the state official is reflected in the corruption indices of Transparency International. Romania has been included in its surveys since 1997 and Bulgaria since 1998. The indices produce a numerical score from 10 as no corruption to 0 1 as all corruption (every transaction with a public employee or politician requires a payment) and a relative ranking. Romania's score and ranking both fell in 1998 when it was 63rd from the least corrupt country (Denmark) out of 85 countries ranked. That put it slightly ahead of Bulgaria. In 1999 their absolute scores both improved slightly and they were both ranked 63rd out of 99. Then they parted ways so that in the 2001 index out of 91 countries, Bulgaria was ranked 47th but Romania 69th. Bulgaria is now tied with the Czech Republic and ahead of the Slovak Republic (at 51st). Romania's ranking put it below that of Moldova (at 63rd). Neither Cyprus nor Malta was surveyed. Romania appears now to be the most corrupt of the 10 candidates for accession. What a contrast Estonia makes at the other end for its score is slightly better than Italy's, while Hungary, Slovenia, and Lithuania have better scores than Greece.

Hellman and Schankerman (2000) approach corruption from the other side, that of business firms buying favors from government officials or so-called "state capture". They use data from the 1999 Business Environment and Enterprise Performance Survey (BEEPS), a joint project of the EBRD and the World Bank that covered 22 transition countries. Bulgaria and Romania are both measured as "high capture" countries, meaning their firms probably engaged in extensive corrupt practices in order to buy favorable rules of the game. Six countries (Azerbaijan, Moldova, Russia, Ukraine, Kygyzstan and Latvia) had higher capture than Bulgaria. By contrast, Romania was at the bottom of the high capture list (behind Croatia, Georgia, and Slovakia). The biggest possible weakness of this index is that it is based of the opinions of firms about other firms' corrupt practices, but this is an issue beyond the author's capacity to judge. A second index of average bribery payments as a share of gross firm revenues shows Romanian payments to be 9th from the top (the largest share of bribes) and Bulgaria down to only 16th, that is, among those with the least share of bribes. Given this intransitivity, one wonders what the survey would show if repeated in 2001 when Romania's relative ranking on the Transparency International index had fallen.

The evolution of corruption since the communist period should be studied more carefully. Under that system people not only cultivated the habit of breaking the rules when it was useful and possible. "Tipping" and bribery were normal in the economy of scarcity. Effective managers broke the rules and even hired "expeditors" in order to obtain supplies and investments. Of course, opportunities for such behavior varied over time and across countries as a function of high level attention. That came and went. Then people returned to their normal behavior. Transition suddenly changed both the (informal) rules and what tips and bribes could be used for.

Corruption occurs in a variety of ways (Bardham 1997, Tanzi 1998), even the classic form of "abuse of public power for private benefit" that is probably being measured by Transparency International. Most researchers believe that corruption increases as state regulation and spending increase, especially when this is accompanied by monopoly and discretionary power. At the same time, some of the least corrupt countries, Denmark for example, have large public sectors. Problems arise in the particular forms of regulation and authorization, taxation, organization of spending decisions, and others. Also, the quality of bureaucracy, the existence of impersonal selection requirements, and the relative level of public wages to private wages matter. Although Tanzi (586) notes that "the many factors that contribute to corruption tend to be more common in poorer countries", he does not list low incomes as a contributing factor.

This contrasts to the popular opinion of all three groups – public officials, households, and enterprises – interviewed in the *Diagnostic Surveys of Corruption in Romania* (World Bank 2001). Here low salaries and poverty were listed most important by nearly half of all interviewees. Households and enterprises listed "desire for personal gain" as second most important. Apparently the survey did not ask if the common attitude accepted bribery and corruption as normal or even unavoidable behavior.

One suspects that in many transition countries such attitudes were carried over from the communist period.

Tanzi extends his observation, cited above, about the common occurrence of corruption-contributing factor to the case of transition economies. One might deduce from his two observations that factors contributing to corruption tend to be more common in poorer transition countries and richer transition countries. Perhaps the same held for poorer and richer communist countries. Neither case has been investigated.

The *Diagnostic Surveys* also ask Romanian households and enterprises to list in order of importance what they believed to be the consequences of corruption. Both listed income variables as first and second. First was a declining standard of living of the population; second was that "the poor get poorer and the rich even richer". The *Diagnostic Surveys* also found that bribe payments had a regressive impact. Households with lower incomes paid higher percentages of income on bribes in general and specifically expenditures for medical care. This fits one of the general empirically measured effects of corruption listed by Tanzi. Besides reducing investment and, in consequence, the rate of growth, corruption reduces public expenditures on education and health and shifts it toward public investments.

Hellman (1998) contends that partial reform equilibrium causes the "rich to get richer and the poor to get poorer" as the song goes. No transition country experienced the great increase in income inequality officially recorded in Russian. However, among the CEECs, Baltics, and SEECs, data in the EBRD Transition Report shows income distribution in Romania now to be the most unequal. Also, Romanian data show the greatest increase in inequality of these countries in the period from 1989-90 to 1995-97. If the positive correlation between corruption and the shadow economy is taken into account (Schneider and Enste 2000) and the likelihood that the share of unreported income is higher for higher reported income, then the increase in income inequality is even greater than these figures suggest.

Conclusions and Recommendations

A careful review of the existing theoretical and empirical on transition economies stresses the differences between the dominant, declining state sector and the initially small, but rapidly emerging private sector. The weight of the former pulled down the whole economy. How soon recovery would take place depended on how soon state owned enterprises could be turned around and how fast private enterprises could grow. Following Berg et al (1999), Havrylyshyn and van Rooden (2000), and Falcetti, Raiser, and Sanfey (2000), the best growth performances have been recorded by countries that undertook fast and comprehensive liberalization and stabilization, followed by prompt development of market-supporting institutions. Countries that followed such a reform course have been able to make up for initially disadvantageous conditions. In this respect, the Baltic Countries have performed better than Bulgaria and Romania. In addition, empirical enterprise studies have shown consistently a relative weakness of Bulgarian and Romanian enterprises in all categories of ownership. In contrast to Hungarian and Polish privatized SOEs, privatization of SOEs in Bulgaria and Romania has not improved performance. This is likely to be the result of the particular form of MEBOs that dominated privatization in these two countries (Earle and Estrin 1996).

The empirical macroeconomic research cited above depends on indicators of initial conditions developed by DeMelo et al (1997) as modified by the EBRD (1999). This list does not include the initial conditions and subsequent spillovers that are emphasized as special problems of the Southeast European countries by Petrakos (2001), such as size, negative spillovers from regional conflicts, and intra-branch distortions of industrial structures. Important questions must be raised about how much Bulgaria and Romania suffered from the first two. It remains to undertake a systematic evaluation of all issues raised by Petrakos on growth and other performance indicators of all 25 transition countries, especially the Baltic countries in terms of a comparison with Bulgaria and Romania.

Neither list of initial conditions adequately identifies conditions that suggest the relative motivations and incentives of political agents at the onset of transition. Also, the dominant line of political economy of transition depends on the assumptions of benign, public welfare seeking political leaders and democracy dominated by the median voter hypothesis. Neither seems to fit the cases of countries in which old line communists took charge in the first post-communist election (Hellman 1998, Fish 1999). The rent-seeking literature, following Krueger (1994) and others, provides a relevant alternative approach and is reflected in the paper of Hellman and Schenkerman (2000) on state governance and capture. All transition countries have undergone two distinct, but interconnected processes. The first redistributed claims on wealth (cash, office equipment, urban cites and structures, farm land and natural resources, company management and ownership claims, and public offices). The second defined the conditions of what Hellman (1998) called the "partial reform equilibrium". Its characteristics are not only the wealth and income claims resulting from the initial redistribution, but also the resulting incentives, possibilities for monopoly and competition, inducement for innovation, and even matters important for regional cooperation such as cross-border cooperation.

While Hellman and Fish treat the character of the first post-reform government as a given, these is good reason to believe that conditions in the communist countries prior to transition determined much of the political character of the first stages of transition. How far had the authority of the communist party been weakened? Had institutions started to be created that could maintain public order during the first difficult political change? How open to the West was a country? How many people had lived and worked in the West? Were there any outstanding economists or political thinkers? Was there an available Diaspora of intellectuals and persons in business? How many westerners were working in the country and what kinds of relationships could be had with them? Were there respected non-communist or dissident figures? What was the mindset of the nomenklatura? Did they feel abused by the leadership, underpaid, and under appreciated? Did they have an elitist mentality compared to the common people? Romania and Hungary differ greatly on all of these points. Bulgaria was more like Romania than Hungary, but it did not suffer the isolation and deprivation of Romania in the 1980s.

Slow privatization in Bulgaria and Romania dragged out and confused the redistribution of wealth. Much of what counted consisted of people getting into the right places, sometimes enterprise management and often well paying offices with insider information. In this sense, the redistribution up to the end of 1996 created structures that were difficult to change. In Romania, the former communists held power throughout the period. Even though former communists did not always organize governments in Bulgaria they were politically the most influential group. A limited body of evidence (example: Gabanyi 1999) has been examined concerning which Romanians grabbed what during this time. It reveals, in likely contrast to the cases of Poland and Hungary (Hanley 2000), that the former "nomenklatura" (code word for a much larger group than the actual nomenklatura of the old system, including high officials in the security and diplomatic services, administrators and regional officials, and managers of enterprises and collective farms) and their families and friends acquired considerable wealth holdings. Research should and could be done in order to verify this record.
Does a transition process caught in a Hellman-like "partial reform equilibrium" mean institutionalization into a Latin-American style of oligarchic capitalism? At this point such an outcome would seem more likely in Romania than in Bulgaria. Yet, in spite of the likely endurance of the new rich in both countries, both internal and external forces might bring on change towards modern European political and economic systems.

Internally, European culture and tax laws have produced few examples of the super rich vesting their fortunes in public-service foundations in the example of Rockefeller, Carnegie, Ford, or Gates. And the children or grandchildren of the European super rich rarely become reform politicians in the model of the Rockefeller brothers. Other internal changes are possible:

1) The new managerial classes might evolve from rent-seekers into entrepreneurs and Schumpeterian innovators.
2) A new generation of well-educated persons might pioneer new technology companies from scratch, in the model of those in Silicon Valley.
3) Returnees from the Diaspora may put their experience in the West to work in the same way.
4) Gradually poorly managed domestic companies might be taken over by foreign investors and domestic monopolies broken by green field foreign investments.

External forces are quite mixed. Russian Lukoil has already taken a strong hold of refining and distributing in both countries. Some foreign investors are suspected being rent-seekers and have the means to bribe officials for the privilege. Being candidates of both the EU and NATO has produced both specific mandates for change and specific incentives for change. One can read the latest EC evaluations of progress for the mandates. Understanding the incentives is more complex. As the process of expansion moves along, specific incentives for and against are defined in both the EU member countries and the candidate countries. The question is not just when expansion will take place, but also if at all and under what division of gains and losses on both sides. The vested interests in Bulgaria and Romania might want to stay out. Who knows what the alternatives will be when and if the offer is made?

This brings the paper to its last observation. There are many excellent plans for promoting cooperation, stability, and development in Southeastern Europe. Preparing for EU membership is one of them. If any plan is to be accepted and carried through, just like all the recommended reforms for transition, there must be specific persons attracted to their benefits and who have enough power to put them in force against the opposition of those who will lose by them. No plan is good that ignores the motivations of those actors and the provision of adequate incentives.

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